

Company Name: Xylem Inc. (XYL)
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<<Michael Halloran, Analyst, Robert W. Baird & Co.>>

All right. Good morning everyone. My name is Mike Halloran, an industrial analyst here at Baird. And we're pleased to once again welcome Xylem with us today. Joining us today is going to be Patrick Decker, President and CEO; and Matt Latino, Manager, Investor Relations. As usual, we're going to run a formal Q&A session after this, formal Q&A – maybe an oxymoron. But if you have a question, please raise your hand or fire me an email, and I'll make sure I'll look at it on the iPad that'll be in front of me. And with that, some prepared remarks from Patrick. Thank you.

<<Patrick K. Decker, President and Chief Executive Officer>>

Thanks, Mike. So good morning, everybody. I'm going to keep my opening comments very, very brief here, so we can really focus more on the Q&A. But for those of you who may not be familiar with the company, real quick here. The company at a glance, again, the company now about 5.5 years old, a spinoff from ITT Corporation, doing about \$4.5 billion of revenue last year, will be close \$5 billion this year. You get a feel for the splits here in terms of the three segments that we've got in the company and with the relative sizes.

Really quickly, our vision, I'm not going to read through the bullets here, but we really do feel that we've got a distinctive competitive edge here in terms of being a pure-play water company and making a number of moves to take first-mover advantage in the digitization of the water sector. We certainly are confident about our ability to drive top quartile performance given fast to the market growth. And I think, certainly, over the last couple of quarters, you're beginning to see that order rate and growth rate begin to pick up. And third, really, being seen as a thought leader in the water sector and all that comes with that.

At a high level, really focused in terms of value creation here on two distinct sets of activities. One is optimizing our base business. There's still a fair amount of self-help story in integrating these businesses internally and building a sustainable culture here. At the same time, there's also an attractive capital deployment opportunity here, given the attractiveness of our balance sheet but more importantly the cash flow profile of the company.

Those of you that may not be familiar, one of the first moves we made in terms of sizable acquisitions – I've been here now for about 3.5 years, was acquisition last year of Sensus, which allowed us not only to get into the metering space but really to leverage their telemetry and data analytics capability across the rest of the legacy Xylem portfolio, but also coupling that with a small tuck-in of Vicenti, which is a leak protection company, to begin to build out a digitization capability of not only the clean water network but also the wastewater network.

Real quick. As a result of the acquisition of Sensus, the cost synergy targets that we committed to and some of the revenue synergies there, we did take our outlook, our long-range outlook through 2020 up from my first Investor Day back in late 2015. So we are now targeting organic growth in the range of 4% to 6%, which would be about 1.5 times the growth of the market. We also improved or increased our operating margin targets by 100 basis points on both the bottom end as well as the top end. You'll see, we're committing to at least a mid-teens EPS growth, and we believe we have an arsenal over that time frame of capital to be deployed, whether it be through acquisitions, repurchases, dividends, et cetera, over that timeframe of north of \$5 billion.

So a pretty healthy arsenal, in our view, of capital to be deployed. Real quick on 2017. If you didn't listen to our earnings call, again, we have taken our organic growth range up slightly now to 3% to 4% for the full year. We're looking at margin expansion of 50 basis points, excluding the purchase accounting amortization for the Sensus transaction committed to EPS growth of 18% to 19% and are looking at free cash flow conversion for a second straight year of well north of 100%. So again, pretty solid year, feel – good momentum in the markets but also feel good about share gains across a number of our product lines.

So last slide, again, I promise to be very quick, Mike, so the bottom line here is we really think that our investment thesis for Xylem is somewhat unique and differentiated, and that is the fact that we are benefiting from a fairly favorable macro outlook given the markets that we serve. We are confident about our ability to gain share and grow faster than the market. We've got a good self-help story here in terms of a long-term margin expansion, not just a one-and-done but certainly, over the course of the next three to four years. And again, a very healthy balance sheet and cash profile to drive attractive capital deployment in the right spaces.

So with that, Mike, I'm going to pause and move into Q&A.

Q&A

<Q – Michael Halloran>: Great. And as a reminder, if you have any questions, just find a way to let me know, either fire me an email, with the card in front of you or just raise your hand. So let's start with a lot of top line questions. First, on the muni side. You're getting some conflicting commentary in the marketplace, some doing a little bit better than others. It seems like it's more specific to what type of product you're selling in the muni space. Obviously, your trends have improved and started to inflect. So maybe talk a little higher level about where the muni marketplace is. And then get a level deeper and talk about where you're winning specifically and what the trends look like.

<A – Patrick K. Decker>: Sure. So when you look at the muni market, you really have to break it down between are you serving the clean water side of the muni market, are you serving the wastewater side of the market and are you serving, what we call, outdoor water or surface water. Each one of those three areas of the market behaves in different patterns and different kind of cycles. And so certainly, as we are heavily focused on the wastewater side of the network, that is a market that tends to be steadier than the clean water side in that you don't find utilities mucking around too much or messing around with deferring or delaying critical investment or

spending there as much as you do on the clean water side because of the risk of enforcement actions if there are breaks in the infrastructure, et cetera.

So other than a few breaks over history, most recently, the global financial crisis where we had an overbuild-out in resi, that led to a pullback in the need for any new treatment facilities being built or new water infrastructure. We've long said that you really should be looking at a market growth in that low to mid-single digit pretty consistently over the cycle. We're certainly seeing that, as we speak right now, on the wastewater side, and we think that supports a continued long runway for us on that part of the market.

Clean water side, there have been some air pockets there in terms of depending on the utility. I think the reason why we've been able to continue attractive growth there, this is really our Sensus business, which has been growing, we're looking at 6% to 7% growth this year, market growth more like in that probably 3% to 4% growth, has been some share gains, some project wins this year that we're beginning to deliver now. But that can be – it's not a choppy business from year-to-year, but it can be choppy from quarter-to-quarter. And so we did see some softness in Q3, but we see a rebound of that given shipping activity in Q4.

And then the outdoor water area, although it's a smaller part of the market, is really driven by EPA regulations across the country, and we've seen that market return to growth this year. It was down the last probably a year, 18 months and certainly rebounding this year.

<Q – Michael Halloran>: On the industrial side, maybe a comparable conversation to watering. Obviously, it's gotten a little bit better. Maybe the opportunity set has gotten a little brighter more broadly through the portfolio. How is that trajectory laid out? Anything that you think can derail that one way or another?

<A – Patrick K. Decker>: Sure. So if you look at our roughly 37%, 38% of our revenue that is what we call industrial, you really need to break that down into two distinct buckets. There is about 6% of that – 6 of those 37 points is really heavy industry, it's oil and gas and mining. And the only reason we've even talk about those businesses the last couple of years was it had declined by 30% and 40%, respectively, the last two years, given what most of our industry peers were experiencing. We saw it, too.

Heavily tied to mining and the fracking industry as well. And the only reason we even talked about it, as you know, Mike, was it was a big enough decline that it actually took away 1 point of organic growth on the top line for the company, but also, it's a business with very attractive margins. And so it was providing a real headwind for us in terms of margin expansion. That part of the business has certainly snapped back here at the last couple of quarters, and we're showing kind of mid, high single-digit growth at a minimum there. And so certainly, as that continues, that's going to be a bit more of a tailwind for us. We're not really declaring victory there yet. We're early in that recovery. But that's really the only reason we'd even talk about that part of industrial.

The rest of our industrial business is what we would consider light industrial. So we're selling into a broad spectrum of users of pumps. This could be a pharmaceutical plant, could be a

chemical plant, could be a refinery. As long as they are up and running, they're going to be burning through a wide variety of our pumps in that facility. We're not tied to production output. It's simply a use and wear and tear. It's a heavy repair and replacement or high – heavy replacement the business for us. And so that business has historically grown about 2% to 3%. It's heavily tied to GDP. It sometimes drops down to maybe just below 2%. We saw it early this year, and it's certainly been a little bit stronger here in the last couple of quarters but pretty steady business.

<Q – Michael Halloran>: Anything different inflection-wise on the commercial resi businesses before we move to innovation?

<A – Patrick K. Decker>: Yes. We've seen good health here, obviously, in the commercial building sector for the U.S. Now we are more heavily tied to the institutional side of that market, so government, universities, airports, those kinds of things, than we are in your classic kind of office building environment, although we certainly sell there as well. So pretty healthy U.S. market right now. And what's been driving our growth in commercial building, really, has been in Europe where we are, really, in the number three or number four position. And with a lot of our new product launches and investments in sales teams, we're certainly winning to share in that part of the globe.

<Q – Michael Halloran>: So let's tackle how you guys are looking at innovation from a couple of avenues. First, Sensus. I think when you first brought Sensus into the fold, you didn't say it was a target but the hope was that you get it somewhere around \$100 million of revenue synergies.

<A – Patrick K. Decker>: Yes.

<Q – Michael Halloran>: Obviously, from the slide earlier, it's now towards \$150 million, \$175 million. So you're feeling better about the opportunity set that Sensus can layer through. Talk about what that means for the portfolio and what you're pursuing with that.

<A – Patrick K. Decker>: Sure. So let me just go back to revenue synergies for one second, just for those that may be new to the story. So part of the revenue synergy is the fact that Sensus, like many of the large metering companies here in North America, are fairly North America-centric, and there are a number of international deployments with large utilities around the world that they've been pursuing early stage, and a number of those are large water utilities that Xylem already has a very good relationship with.

Now that does not, by any means, a guarantee of victory, but it certainly helped us open the door and give them a little bit more runway there. And so we certainly are hopeful and optimistic that we will be able to convert some of those into wins, and those tend to be large-scale deployments that certainly would add a very attractive level of revenue to the portfolio.

Turning more to the technology piece and the leverage there, we didn't pursue Sensus for sake of getting into the metering business, although the metering market can be a very attractive market with good margins and good growth. We looked at Sensus in terms of, in our view, certainly, a

best-in- breed technology from not so much just a meter but really, the telecommunications network and framework as well as some data analytics capabilities that they had acquired and been building over the last few years.

And we long saw there being an opportunity to leverage that digital and data analytics capability into other parts of the utilities framework beyond clean water. So really getting into wastewater networks as well as outdoor water, and there are very specific pain points that utilities have in those areas that, today, it's a pretty fragmented delivery to them on those solutions if they're even participating at all. So we felt that was a first-mover advantage for us, given our position in wastewater and outdoor water.

Now there are other pain points on the clean water side of the network that many of us are going after, and we can certainly talk about those at some point, Mike. But I'd say, we are in the early stages of executing some pilots with those utilities, both here in the U.S. as well as globally. And we expect to see some of those wins begin to come to the front in 2018.

<Q – Michael Halloran>: So where does the focus lie there then? Is it more on getting the Sensus equipment into the network, being able to transmit the data through FlexNet and through your dedicated network to a centralized node so somebody else can manage the data? Or are you also focused on the data management as well?

<A – Patrick K. Decker>: It goes both ways. So you've got – it's a split. You've got some utilities who they want to own and manage that data themselves. They're looking for us to give them knowledge and insight, so they can then go and take that action. There are other utilities that are looking for us to actually provide that service to them, and that's where we see the growth in our – the SaaS piece of our business. It's still a small piece of our overall portfolio today in terms of revenue, but it's one of the fastest-growing that we see in the portfolio, and that's what gives us a proof point that there is – utilities have long been criticized for being risk-averse, slow-to-adopt technology.

Well, that's – while that's true, I think it's a little unfair to utilities. I mean, this is a high risk of failure for them, and therefore, they can't afford to take a lot of new chances. But when they are working with a trusted service provider that's been with them for a number of years, they are more than willing to go out and do pilots to be able to prove the technology, and that's why this is a little bit of a slower conversion, but I'm very convinced that we're seeing that adoption.

<Q – Michael Halloran>: That's actually a good segue to where I wanted to go next. So from an innovation perspective, do you find that the utilities now are more willing to pursue these because they're seeing the potential for benefits?

<A – Patrick K. Decker>: Yes. It's interesting. I've heard from a number of utility CEOs that they don't always say it the same way, but there're three themes that cut through when they talk about their willingness to go pilot a new technology. First of all, it has to reduce their operating expense immediately. This can't be something that has a long payback or has to be proof of concept over a long period of time. They're busy. They've got headaches to deal with. So they

want quick pilots, and they want to see that it's going to have an immediate reduction in operating expense.

Second of all, it has to be sustainable. They are skeptical when people come in and sell them a new platform. They're concerned that within a matter of three to four years, the technology is going to change, and they're going to be chasing it over time. The third is they're increasingly worried about the security of their network. Whether it be cybersecurity or whether it be the physical security of the network. And so they're always interested in technologies that will meet that purpose as well.

The last thing on that, I'd say, Mike, would be we're also seeing a generational shift. You're seeing a retirement of a number of utility operators, and they're being succeeded by people that are of a different generation, that are very comparable and savvy with smart technology and user-friendly smart devices, and they want to be able to apply that to their solutions as well. But it's a slow conversion.

<Q – Michael Halloran>: Yes. So there have been a bunch of strategy and capital deployment questions, this one, first from the audience. So we've seen large conglomerates largely exit the water space as many weren't able to make sufficient returns on the water, so we've seen GE Water leave. Obviously, Siemens Water now Evoqua, that's public. What did these big industrials get wrong in terms of what did they miss in investing in the water space? And what are you doing differently that can create a structurally higher profit making industry.

<A – Patrick K. Decker>: Sure. Well, I mean, I – it's probably hard for me to – not having been to inside the boardrooms and the meeting rooms in those organizations to know exactly what's there. I mean, we obviously observe them. We don't really in many cases compete directly with them. We have a – the common theme with both of those businesses was obviously a heavy exposure to treatment, but a lot of other aspects of the business is beyond treatment.

And what I have certainly learned over the years, and I'm sure they have as well is just because you are playing in the water sector, doesn't mean you're going to have incredible growth rates or make tons of money. It's a very fragmented sector. You know that better than anybody, Mike. It's very fragmented. You really have to pick areas that are niche but with some size and scale of a global nature.

I think, too, you really have to be global. You can't just be highly depend and reliant on one large geography or a few of them. And I think that like any portfolio, you've got to be really disciplined in terms of your capital allocation within your own business and make some tough calls on your portfolio. And I would say, those companies and others have tended to be a house of a lot of things. Now we have some of that ourselves, and that's why you've seen us prune our portfolio a little bit over the last few years, and we'll continue to put a very sharp eye on the assets that we've got in our business as well.

<Q – Michael Halloran>: So let's talk about allocation of capital. First, externally, you've got about \$5 billion over the next few years that you plan on spending. Segmented marketplace, how do you – as you're rolling in on the best opportunity set because, frankly, there's not a ton of

scaled buyers in the marketplace, and there's an element of, I don't know, can kind of pick and choose where they want to put that capital, so how do they – how do you guys narrow that down?

<A – Patrick K. Decker>: Sure. So we started, about 3.5 years ago when I joined, doing – we – quite frankly, we're probably suffering a little bit of what some of the other players that you talked about were suffering from, and that was we didn't – at least, in the case of Xylem, we didn't really have clarity on what parts of the water sector were we going to play in and then how are we going to win in those sectors.

So we spent a lot of time in my first year getting the team engaged and our board engaged in basic value mapping of the water sector. And so we looked at like 65 different subsectors of water through the lens of the users or producers of water, and that really was what narrowed it down to. We saw there, this opportunity to bring digital solutions to the water utility sector around certain pain points. We saw the opportunity in the industrial landscape. You are seeing a shift in regulatory burden and funding burden towards the industrial user of water to do initial level of treatment, discharge, et cetera.

So those are areas that we certainly have found to be attractive and priority for us, along with what I talked about in terms of the outdoor water space. We are – I know every management team says this, and so take it on faith, I guess, or proof in the pudding, we're very disciplined on our return on capital metrics. And so there are a lot of opportunities out there. We do see just about every water opportunity that comes along of any size and scale, but we're very careful around the multiples on these businesses that we're willing to pay. I think we proved that with Sensus in terms of being a very attractive multiple. We paid there with good synergies, and we expect to be as disciplined as we look at other opportunities that are out there.

So we've got a well-honed, well-seasoned corporate development and M&A team with a good strategy team, and we have pipeline reviews on a regular basis. It's a healthy pipeline. But there are things with size and scale, and there are things that are small that we'll continue to look at.

<Q – Michael Halloran>: Other multiples right now?

<A – Patrick K. Decker>: It's always in the eye of the beholder. So I'd say, they're a little frothy. I don't think the – some of the drivers that are out there right now in terms of people's expectations, I think that our ability to have gotten Sensus at the multiple we did was probably a little bit of a correction in the so-called metering market. And I think what you're seeing right now in some of the industrial assets is there's probably a little bit of adjustment there that could be used.

<Q – Michael Halloran>: Fair enough. So when we think about where you're allocating your internal capital dollars, obviously, Sensus, bridging that through the broader portfolio is one area of focus. You've done more segmentation work since you came onboard to really fine tune where you want to put those dollars. What are the priority sets internally right now?

<A – Patrick K. Decker>: Yes. So I would say, the – there are a few key priorities that we're really focused on. One is we will continue to make investments to take advantage of our position in the emerging markets. And that predominantly being in China, India and the Middle East, and I would say, we just brought onboard a new leader for South America, and I – we'll be expecting we'll make some investments there.

The good thing about our emerging markets platform is it's not capital-intensive, so we can do factory expansion and make investments in R&D and local engineering at a pretty low price. The second area is, again, leveraging the telemetry and the data analytic capability of Sensus across our legacy Xylem business, and that's where we've been making our investments in R&D and engineering this year. We indicated in the third quarter, you saw some downward pressure on our Sensus margins, and that was completely and entirely the investments we made in our Center of Excellence there in Sensus.

So those costs get charged to the Sensus P&L, but that's to support the broad Xylem effort. And then I would say, the third area of focus right now is really building out the selling of the new value propositions that we're building with the Sensus combination. This is the new selling model for some of our teams with the utilities.

<Q – Michael Halloran>: So on the profitability side, a couple of questions. First, how are you thinking about inflation, not just on the commodity side but more broadly, labor, sourcing, supply chain? And how, in front of that, do you feel you are in the price-cost curve?

<A – Patrick K. Decker>: Yes. We've seen a little bit of an uptick in inflation here through the beginning of this year through the third quarter, but it's, quite frankly, been manageable for us. We haven't seen some of the commodity headwinds that some of our metering competitors had called out. And I'd say – because we just have different composition material that we use in the meter there.

On the pump side of the business, I would say, we've seen a little bit of inflationary pressure just due to demand on the wastewater side of the business, but we've also been able to pass that along in terms of price [indiscernible] so that's actually not a bad environment for us to be in. And I would say, the rest of the business is pretty much neutral. What we've been able to do is we've put in place for the first time, about 2.5 years ago, a global procurement team. So when these businesses were within ITT, they each had their own version of procurement opportunity, but nobody was leveraging scale across the portfolio.

So we built that team back in late 2015. And prior to putting it in place, we were doing about \$15 million a year in sourcing savings. That was up to north of \$80 million last year. We're doing more than that this year and expect to do even more next year. So that's really allowed us to not only cover inflation but also reinvest some of those savings in the business.

<Q – Michael Halloran>: And then the last one here, spacing on the profitable side. Obviously, margins have been a nice story for you from a multi-year period here. The forward targets imply continued progression from here. Why the confidence from an industry perspective to drive what

are already very good margins higher? And what are the main focal points? What are the main initiatives?

<A – Patrick K. Decker>: Great question. So I alluded in my opening there very briefly in the drive-by that there is still a self-help story here on the margin front. And so there really are four key levers that we're counting on for the margin expansion. The first is we've got pretty attractive incremental margins on our organic volume growth of somewhere between 30% and 35%, we've built into our long-range outlook. Second of all, we're counting on \$15 million of net synergy, cost synergies from the Sensus integration, and we're filling that this year, and we expect to wrap that up by the end of next year. And that certainly is a boost to our margins.

The third is, I mentioned, we're still in the early innings for deployment of procurement on a global scale but also, our deployment of lean initiatives across the company. And I think a number of you that have had a chance to come with us on-site tours and visits see that we really still are in the early stage there, but the culture really is taking on now, and that's a long runway for us. The fourth area is the simplification of our business.

So we've committed to \$75 million to \$90 million of predominantly G&A take-out from what we call, Global Business Services, really outsourcing certain functions and centralizing others. But that's a longer-term journey that we expect to be happening over the course of 2019 and 2020.

<<Michael Halloran, Analyst, Robert W. Baird & Co.>>

Great. Well, thank you, Patrick, for your time today. Please join me in thanking Xylem.

<<Patrick K. Decker, President and Chief Executive Officer>>

Thank you.

<<Michael Halloran, Analyst, Robert W. Baird & Co.>>

Management will be available on the 2th floor of Walden room, for a breakout session. Presenting next in this room is Acuity Brands. Presenting next in the North Ballroom is Ecolab. Venus Company is presenting in the State room. Badger Meter is presenting in the La Salle room. And Clarians is in the Delaware room. Thank you.